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Senate Bills 1038 and 1052 (as enacted)

PUBLIC ACTS 433 & 434 of 2008

Sponsor: Senator Nancy Cassis (S.B. 1038)
Senator Mark C. Jansen (S.B. 1052)
Senate Committee: Finance
House Committee: Tax Policy

Date Completed: 4-14-09

CONTENT

Senate Bill 1038 amended the Michigan Business Tax (MBT) Act to exclude from the definition of "gross receipts" certain proceeds, interest income, royalties, dividends, taxes, fees, and surcharges.

Senate Bill 1052 amended the MBT Act to do the following:

-- **Eliminate from the calculation of Federal taxable income a bonus depreciation deduction for certain property and a deduction for income attributable to domestic production activities.**
-- **Allow a bonus depreciation credit for a taxpayer other than a regulated utility.**
-- **Revise the 2008 tax year limit on the combined depreciation and compensation credit for an electric or gas utility service provider that makes capital investments in distribution assets.**
-- **Revise the definition of "foreign operating entity" as it pertains to operations outside Puerto Rico.**

The bills are retroactive and effective January 1, 2008. The bills were tie-barred to each other.

Senate Bill 1038

"Gross Receipts"

Section 203 of the MBT Act imposes a modified gross receipts tax on every taxpayer with nexus as determined under the Act. The tax is imposed on the modified gross receipts tax base, after allocation or apportionment to the State at a rate of 0.80%.

Previously, "gross receipts" meant the entire amount received by the taxpayer from any activity whether in intrastate, interstate, or foreign commerce carried on for direct or indirect gain, benefit, or advantage to the taxpayer or to others, except for certain proceeds, interest earned, or other receipts excluded under the Act.

Under the bill, "gross receipts" means the entire amount described above as determined by using the taxpayer's method of accounting used for Federal income tax purposes, less any amount deducted as bad debt for Federal income tax purposes that corresponds to items of gross receipts included in the modified gross receipts tax base for the current tax year or a past tax year phased in over a five-year period starting with 50% of that amount in the 2008 tax year, 60% in the 2009 tax year, 60% in the 2010 tax year, 75% in the 2011 tax year, and 100% in the 2012 tax year and each subsequent tax year.

Exclusions from "Gross Receipts"

The bill revised certain amounts and proceeds previously excluded from the definition of gross receipts, and excluded additional amounts and proceeds as described below.

Collected Taxes & Fees. The bill excludes from the definition of gross receipts each of the following:

-- Sales or use taxes collected from or reimbursed by a consumer or other taxes the taxpayer collected directly from or was reimbursed by a purchaser and remitted to a local, State, or Federal tax authority.
-- In the case of receipts from the sale of motor fuel by a person with a motor fuel tax license or a retail dealer, an amount equal to Federal and State excise taxes paid by any person on such motor fuel under Section 4081 of the Internal Revenue Code (IRC) or under other applicable State law.
-- In the case of receipts from the sale of beer, wine, or intoxicating liquor by a person holding a license to sell, distribute, or produce those products, an amount equal to Federal and State excise taxes paid by any person on or for such beer, wine, or intoxicating liquor under Subtitle E of the IRC or other applicable State law.
-- In the case of receipts from the sale of communication, video, internet access and related services and equipment, any government-imposed tax, fee, or other imposition in the nature of a tax or fee required by law, ordinance, regulation, ruling, or other legal authority and authorized to be charged on a customer's bill or invoice (not including the recovery of net income taxes, net worth taxes, property taxes, or the tax imposed under the Act).
-- In the case of receipts from the sale of electricity, natural gas, or other energy source, any government-imposed tax, fee, or other imposition in the nature of a tax or fee required by law, ordinance, regulation, ruling, or other legal authority and authorized to be charged on a customer's bill or invoice (not including the recovery of net income taxes, net worth taxes, property taxes, or the tax imposed under this Act).
-- Any deposit required under the beverage container deposit law (which requires 10 cent deposits for certain beverage containers); Rule 436.1629 of the Michigan Administrative Code (which requires $30 deposits on barrels, half barrels, and quarter barrels of beer); Rule 436.1723a (which requires $10 deposits on barrels, half barrels, and quarter barrels of wine); or any substantially similar beverage container deposit law of another state.
-- An excise tax collected pursuant to the Airport Parking Tax Act, collected from or reimbursed by a consumer and remitted as provided in the MBT Act.

The amounts described above may be excluded to the extent not deducted as purchases from other firms under Section 203, and are phased in over a five-year period starting with 50% of the amount in the 2008 tax year, 60% in the 2009 tax year, 60% in the 2010 tax year, 75% in the 2011 tax year, and 100% in the 2012 tax year and each subsequent tax year.

The bill also excludes from the definition of gross receipts, in the case of receipts from the sale of cigarettes or tobacco products by a wholesale dealer, retail dealer, distributor, manufacturer, or seller, to the extent not deducted as purchases from other firms under Section 203, an amount equal to the Federal and State excise taxes paid by any person on or for the cigarettes or tobacco products under Subtitle E of the IRC or other applicable State law. This exclusion is phased in over a three-year period starting with 60% of that amount in the 2008 tax year, 75% in the 2009 tax year, and 100% in the 2010 tax year and each subsequent tax year. (Subtitle E of the IRC pertains to alcohol, tobacco, and certain other excise taxes.)

<u>Ownership Interest in a Pass Through Entity</u>. The bill excludes from the definition of gross receipts amounts attributable to an ownership interest in a pass-through entity, regulated investment company, real estate investment trust, or cooperative corporation whose business activities are taxable under Section 203 or would be subject to the tax under Section 203 if the business activities were in this State.

For purposes of this provision, "cooperative corporation" means those organizations described under Subchapter T of the IRC (which pertains to the taxation of cooperative corporations including farmers' cooperatives and other corporations operating on a cooperative basis). "Pass-through" entity means a partnership, subchapter S corporation, or other person, other than an individual, that is not classified for Federal income tax purposes as an association taxed as a corporation.

"Real estate investment trust" means that term as defined under Section 856 of the IRC (i.e., a corporation, trust, or association managed by one or more trustees or directors; that otherwise would be taxable as a domestic corporation; the beneficial ownership of which is held by 100 or more people; that derives a certain percentage of its gross proceeds from dividends, interest, rent from real property, and other income related to real property; and that meets other requirements of IRC).

"Regulated investment company" means that term as defined under Section 851 of the IRC (i.e., any domestic corporation that, at all times during the taxable year is registered under the Investment Company Act of 1940 as a management company or unit investment trust, or has in effect an election under that Act to be treated as a business development company, or that is a common trust fund or similar fund excluded by that Act from the definition of "investment company" and is not included in the definition of "common trust fund"; that denies 90% of its gross income from dividends, interest, payments with respect to securities loans, and gains from the disposition of stock or securities, and other net income; and that meets other criteria).

Receipts Derived from Investment Activity. The bill excludes from the definition of gross receipts, for a regulated investment company as defined by Section 851 of the IRC, receipts derived from investment activity by that regulated investment company.

Medicaid Premium or Reimbursement. The bill excludes from the definition of gross receipts amounts received by a taxpayer during a fiscal year for Medicaid premium or reimbursement of costs associated with service provided to a Medicaid recipient or beneficiary unless the State Budget Director certifies to the State Treasurer by January 1 of that fiscal year that the federally certified rates for actuarial soundness required under 42 CFR 438.6 (which pertains to comprehensive risk contracts entered into by a state agency) and that are specifically developed for Michigan's health maintenance organizations that hold a contract with this State for Medicaid services, provide explicit adjustment for their obligations required for payment of the tax under the MBT Act. The exclusion applies for fiscal years that begin after September 30, 2009.

Newspaper Advertising Space. The bill excludes from the definition of gross receipts amounts received by a newspaper to acquire advertising space not owned by that newspaper in another newspaper on behalf of another person. This provision does not apply to any consideration received by the taxpayer for acquiring that advertising space.

Stock or Equity Instruments. Under the Act, proceeds from the original issue of a stock, equity instruments, and debt instruments are not included in gross receipts. The bill also excludes equity issued by a regulated investment company as defined by Section 851 of the IRC.

Receipts from Investment Activity. The bill excludes from the definition of gross receipts derived from investment activity by a person that is organized exclusively to conduct investment activity and that does not conduct investment activity for any person other than an individual or a person related to that individual or by a common trust fund established under the Collective Investment Funds Act. For purposes of this provision, a person is related to an individual if that person is a spouse, brother or sister, whether of the whole or half blood or by adoption, ancestor, lineal descendent of that individual or related person, or a trust benefiting that individual or one or more people related to that individual.

Interest Income & Dividends. The bill excludes from the definition of gross receipts interest income and dividends derived from obligations or securities of the United States government, this State, or any governmental unit of this State. As used in this provision, "governmental unit" means that term as defined in Section 3 of the Shared Credit Rating Act (i.e., this State, a county, city, township, village, school district, intermediate school district, community college, public university, authority, district, any other body corporate and politic or other political subdivision, any agency or instrumentality of those entities, or any municipal group self-insurance pool).

Dividends & Royalties. The bill excludes from the definition of gross receipts dividends and royalties received or deemed received from a foreign operating entity or a person other than a United States person, including the amounts determined under Sections 78 and 951 to 964 of the IRC, phased in over a five-year period starting with 50% of that amount in the 2008 tax year, 60% in the 2009 tax year, 60% in the 2010 tax year, 75% in the 2011 tax year, and 100% in the 2012 tax year and each subsequent tax year.

(Section 78 pertains to dividends received from certain foreign corporations by domestic corporations choosing a foreign tax credit. Sections 951 to 964 pertain to income and earnings of controlled foreign corporations.)

<u>Proceeds from a Transaction</u>. The MBT Act previously excluded from gross receipts proceeds from a sale, transaction, exchange, involuntary conversion, or other disposition of tangible, intangible or real property that was a capital asset as defined in Section 1221a of the IRC or land that qualified as property used in the trade or business as defined in Section 1231b of the IRC, less any gain from the disposition to the extent that gain was included in Federal taxable income.

Under the bill, proceeds from a sale, transaction, exchange, involuntary conversion, maturity, redemption, repurchase, recapitalization, or other disposition or reorganization of tangible, intangible, or real property, less any gain from the disposition or reorganization to the extent that the gain is included in the taxpayer's Federal taxable income, are excluded from gross receipts if the property satisfies one or more of the following:

-- It is a capital asset as defined in Section 1221(a) of the IRC.
-- It is land that qualifies as property used in the trade or business as defined in Section 1231(b) of the IRC.
-- It is used in a hedging transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily to manage the risk of exposure to foreign currency fluctuations that affect assets, liabilities, profits, losses, equity, or investments in foreign operations; interest rate fluctuations; or commodity price fluctuations.
-- It is investment and trading assets managed as part of the person's treasury function.

For property used in a hedging transaction, the actual transfer of title of real or tangible personal property to another person is not a hedging transaction. Only the overall net gain from the hedging transactions entered into during the tax year is included in gross receipts. "Hedging transaction" means that term as defined under Section 1221 of the IRC regardless of whether the transaction was identified by the taxpayer as a hedge for Federal income tax purposes, provided that transactions excluded under this provision and not identified as a hedge for Federal income tax purposes are identifiable to the Department of Treasury by the taxpayer as a hedge in its books and records.

For property that is an investment and trading assets managed as part of the person's treasury function, a person principally engaged in the trade or business of purchasing and selling investment and trading assets is not performing a treasury function. Only the overall net gain from the treasury function incurred during the tax year is included in gross receipts. "Treasury function" means the pooling and management of investment and trading assets for the purpose of satisfying the cash flow or liquidity needs of the taxpayer's trade or business.

(Under Section 1221(a) of the IRC, "capital asset" means property held by the taxpayer, whether or not connected with his or her trade or business, not including certain stocks, property, copyrights or artistic compositions, accounts or notes receivable, or publications of the U.S. government, as described in the Code.

Under Section 1231(b), "property used in the trade or business" means property used in the trade or business, of a character that is subject to the allowance for depreciation provided under the Code, held for more than one year, and real property used in the trade or business, held for more than one year and subject to certain provisions.)

<u>Amounts Received for Estate or Gift Planning Purposes</u>. Previously, the Act excluded from gross receipts for an individual, estate, or partnership or trust organized exclusively for

estate or gift planning purposes, amounts received other than those from transactions, activities, and sources in the regular course of the taxpayer's trade or business, including the following:

-- Receipts from tangible and intangible property if the acquisition, rental, management, or disposition of the property constituted integral parts of the taxpayer's regular trade or business operations.
-- Receipts received in the course of the taxpayer's trade or business from stock and securities of any foreign or domestic corporation and dividend and interest income.
-- Receipts derived from isolated sales, leases, assignment, licenses, divisions, or other infrequently occurring dispositions, transfers, or transactions involving property if the property was used in the taxpayer's trade or business operation.
-- Receipts derived from the sale of a business.

Receipts excluded from gross receipts under these provisions for an individual, estate, or partnership or trust organized exclusively for estate or gift planning purposes, included the following:

-- Personal investment activity, including interest dividends, and gains from a personal investment portfolio or retirement account.
-- Disposition of tangible intangible, or real property held for personal use and enjoyment, such as a personal residence or personal assets.

Under the bill, for an individual, estate, or other person organized for estate or gift planning purposes, gross receipts exclude amounts received other than those from transactions, activities, and sources in the regular course of the taxpayer's trade or business. Amounts received from transactions, activities, and sources in the regular course of the taxpayer's business include the following:

-- Receipts from tangible and intangible property if the acquisition, rental, lease, management, or disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.
-- Receipts received in the course of the taxpayer's trade or business from stock and securities of any foreign or domestic corporation and dividend and interest income.
-- Receipts derived from isolated sales, leases, assignments, licenses, divisions, or other infrequently occurring dispositions, transfers, or transactions involving tangible, intangible, or real property if the property is or was used in the taxpayer's trade or business operation.
-- Receipts derived from the sale of an interest in a business that constitutes an integral part of the taxpayer's regular trade or business.
-- Receipts derived from the lease or rental of real property.

Receipts excluded from gross receipts include the following:

-- Receipts derived from investment activity, including interest, dividends, royalties, and gains from an investment portfolio or retirement account, if the investment activity is not part of the taxpayer's trade or business.
-- Receipts derived from the disposition of tangible, intangible, or real property held for personal use and enjoyment, such as a personal residence or personal assets.

<u>Inventory</u>

Under the Act, "inventory" includes for a person that is a broker or dealer or a person included in the unitary business group of that broker or dealer that buys and sells for its own account, contracts that are subject to the Commodity Exchange Act, the cost of securities as defined under Section 475(c)(2) of the IRC and the cost of commodities as defined under Section 475(e)(2), excluding interest expense other than interest expense related to repurchase agreements.

Under the bill, this provision also applies to a person that is a "securities trader", which means a person that engages in the trade or business of purchasing and selling investments and trading assets. Inventory for a securities trader includes the cost of commodities as defined under Section 475(e)(2) of the IRC, excluding interest expense other than interest expense related to repurchase agreements.

(Under Section 475(c)(2), "security" means any share of stock in a corporation; partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; note, bond, debenture, or other evidence of indebtedness; interest rate, currency, or equity notional principal contract; evidence of an interest in, or a derivative financial instrument in, any security described above, or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency; and any position that is not a security described above, is a hedge with respect to such a security, and is clearly identified in the dealer's records as being described in this provision before the close of the day on which it was acquired or entered into.

Under Section 475(e)(2), "commodity" means any commodity that is actively traded; any notional principal contract with respect to any actively traded commodity; any evidence of an interest in, or a derivative instrument in, any actively traded commodity or notional principal contract with respect to an actively traded commodity, including any option, forward contract, futures contract, short position, and any similar instrument in such a commodity; and any position that is not a commodity described above, is a hedge with respect to such a commodity, and is clearly identified in the taxpayer's records as being described in this provision before the close of the day on which it was acquired or entered into.)

Senate Bill 1052

Federal Taxable Income

Except as otherwise provided, the MBT is a business income tax on taxpayers with business activity in this State. The tax is imposed on the business income tax base, after allocation or apportionment to this State, at the rate of 4.95%. "Business income" means that part of Federal taxable income derived from business activity. Previously, "federal taxable income" meant taxable income as defined in Section 63 of the IRC.

Under the bill, "federal taxable income" means taxable income as defined in Section 63 of the IRC except that it must be calculated as if Section 168(k) and Section 199 of the IRC were not in effect.

(Under Section 63 of the IRC, taxable income means gross income minus Federal deductions allowed under the Code. Section 168(k) allows an additional or bonus depreciation deduction for the taxable year in which qualified property, including certain computer software, water utility property, transportation property, and other property described in the Code, is placed in service, equal to 30% of the adjusted basis of the property.

Section 199 allows as a deduction an amount equal to 9% of the lesser of the qualified production activities income of the taxpayer for the taxable year, or taxable income for the taxable year. "Qualified production activities income" for any taxable year means an amount equal to the excess of the taxpayer's domestic production gross receipts for the taxable year, over the sum of the cost of goods sold that are allocable to such receipts, and other expenses, losses, or deductions that are properly allocable to such receipts.)

Combined Depreciation & Compensation Credit

Under the Act, for the 2008 tax year, a taxpayer may claim a credit against the MBT equal to 2.32% multiplied by the result of an equation described in the Act based on the amount paid or accrued in the taxable year for tangible assets and mobile tangible assets of a type that are, or under the IRC will become, eligible for depreciation, amortization, or accelerated capital cost recovery for Federal income tax purposes. For the 2009 tax year and each tax year after 2009, a taxpayer may claim an MBT credit equal to 2.9% multiplied by the result of the equation.

Subject to criteria in the Act, a taxpayer also may claim a credit for the 2008 tax year equal to 0.296% of the taxpayer's compensation in this State, and for the 2009 tax year equal to 0.37% of its compensation.

For the 2008 tax year, the total combined credit allowed may not exceed 50% of the tax liability imposed under the Act before the imposition and levy of the MBT surcharge. For the 2009 tax year and each tax year after 2009, the total combined credit allowed may not exceed 52% of the tax liability imposed under the Act before the imposition and levy of the surcharge. Under the bill, this provision for the 2008 tax year applies except as provided below.

Under the bill, for a taxpayer primarily engaged in furnishing electric and gas utility service that makes capital investments in electric and gas distribution assets for which a portion of the credit would be denied for the 2008 tax year by reason of the 50% limitation on the total combined credit, that limitation must be increased by an amount not to exceed the lesser of the amount of the denied credit or 50% of the MBT increase accrued for financial reporting purposes due to the bill's elimination of the deduction under Section 168(k) of the IRC. The total combined credit for the 2008 tax year, however, may not exceed 80% of the tax liability imposed under the MBT Act after the imposition and levy of the MBT surcharge.

Bonus Depreciation Credit

Under the bill, for tax years beginning after December 31, 2008, and ending before January 1, 2011, a taxpayer other than a regulated utility may claim a credit under the MBT Act equal to 0.42% of the amount of the deduction claimed for the 2008 tax year for bonus depreciation under Section 168(k) of the IRC apportioned as the tax base is apportioned under the MBT Act. If the amount of the credit exceeds the liability of the taxpayer, the excess may not be refunded but may be carried forward for 10 years or until used up, whichever occurs first.

Foreign Operating Entity

The bill redefines "foreign operating entity" as a United States person that satisfies each of the following:

-- Would otherwise be a part of a unitary business group that has at least one person included in the unitary business group that is taxable in this State.
-- Has substantial operations outside the United States, the District of Columbia, any territory or possession of the United States except for the Commonwealth of Puerto Rico, or a political subdivision of any of the foregoing.
-- At least 80% of its income is active foreign business income as defined in the IRC.

Previously, the definition was the same except the person had to have substantial operations outside the U.S., the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the U.S., or a political subdivision of any of them.

MCL 208.1111 (S.B. 1038)
MCL 208.1109 et al. (S.B. 1052)

Legislative Analyst: Craig Laurie

FISCAL IMPACT

Senate Bill 1038 will reduce Michigan Business Tax revenue to the General Fund by approximately $115.8 million in FY 2008-09 and $80.5 million in FY 2009-10. In contrast, the provisions of Senate Bill 1052 will increase Michigan Business Tax revenue to the General Fund by approximately $172.5 million in FY 2008-09 and $23.4 million in FY 2009-10. The net revenue impact will be to increase FY 2008-09 revenue by $56.7 million and lower FY 2009-10 revenue by $57.1 million.

Fiscal Analyst: David Zin

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